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IN THE

Supreme Court of the United States

No. 74-1155

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE and JAMES F. MORRILL,

Petitioners,

vs.

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioners,

VS.

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Second Circuit which reversed a judgment of the United States District Court for the Southern District of New York dismissing the complaint herein for failure to state a claim upon which relief could be granted.

Opinions Below

The opinion of the United States District Court appears as Appendix A and is reported at CCH Fed. Sec. L. Rep. ¶ 94,163 (S.D.N.Y. 1973). Two opinions of the Court of

Appeals were filed, a majority opinion and a concurring opinion. They appear as Appendix B and are reported at 507 F.2d 374 (2d Cir. 1974).

Jurisdiction

The judgment of the Court of Appeals is dated October 31, 1974, and was entered on that date. A timely petition for rehearing, with suggestion for rehearing *in banc*, was denied by orders dated December 27, 1974, which are set forth as Appendix C. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. Does a complaint alleging violations of Section 14(a) of the Securities Exchange Act of 1934 ("the 1934 Act"), and Rule 14a-9 promulgated thereunder, relating to proxy statements, state a meritorious cause of action for damages when:

(a) The complaint does not allege any causal connection between the proxy statement and any injury to plaintiff;

(b) It is conceded that, as a result of management's voting power, the corporate transaction in question could have been effected irrespective of the alleged defects in the proxy statement; and

(c) It is also conceded that plaintiff was neither deceived nor misled by the proxy statement in any way?

2. Does a complaint state a meritorious cause of action for damages under Section 10(b) of the 1934 Act, and Rule

10b-5 promulgated thereunder, when the complaint does not allege any acts of deception or misrepresentation on the part of any defendant, but only purported claims of corporate mismanagement?

Statutes and Rules Involved

This case involves Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) and Rule 14a-9 (17 C.F.R. § 240.14a-9) promulgated thereunder, and Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and Rule 10b-5 (17 C.F.R. § 240.10b-5) promulgated thereunder, all of which are set forth in Appendix D hereto.

Statement of the Case

This is an action for damages, predicated on the federal securities laws, which was instituted by an alleged minority shareholder of Continental Steel Corporation ("Continental"), assertedly on behalf of himself and "all present shareholders of Continental Steel Corporation similarly situated." The defendants are Penn-Dixie Cement Corporation ("Penn-Dixie"), alleged to be the holder of the majority of the outstanding stock of Continental, and certain directors and officers of Continental and Penn-Dixie.

The complaint was filed shortly after a proxy statement concerning a proposed merger between Continental and a wholly-owned subsidiary of Penn-Dixie was mailed to shareholders of Continental. The nub of the complaint is that this proxy statement was omissive in several respects, particularly in failing to disclose certain alleged instances of mismanagement of Continental by Penn-Dixie and the individual defendants.

It is undisputed that, by virtue of Penn-Dixie's majority ownership, the merger could have been effected irrespective of the alleged defects in the proxy statement, and that the proxy statement did not deceive or mislead plaintiff into entering into a transaction he otherwise would have foregone. Indeed, there are no such allegations with respect to causation contained in the complaint.

Moreover, plaintiff does not allege that he was misled into foregoing any other activity with respect to the merger. The complaint was filed five weeks prior to the consummation of the merger, and plaintiff had more than ample opportunity to seek injunctive relief, but voluntarily chose not to do so. Under applicable law, appraisal rights were not available to stockholders of Continental. Thus, there is no claim that plaintiff was defrauded out of the opportunity to seek these remedies or to take any other measures in an effort to prevent the merger.

The other counts of the complaint allege, in conclusory terms, purported acts of corporate mismanagement and breach of fiduciary duty relating to the operations of Continental; these allegations generally assert, as the Complaint puts it, that "the interests of the stockholders of Continental have been seriously prejudiced since Penn-Dixie has caused Continental to be managed for its benefit and to the detriment of its public stockholders." These claims, while purportedly asserted under Rule 10b-5, do not allege any acts of deception, misrepresentation or fraud on the part of any defendant, and do not claim that plaintiff was deceived or misled by defendants in any way. Plaintiff merely alleges, again solely in conclusory terms, that these mismanagement acts were part of a "scheme" to affect Continental's stock price in some unspecified manner, although no effort is made to allege how these acts actually had this supposed effect.

The District Court dismissed the proxy statement claim, holding that it "need not choose" between the standards of causation which have been applied by the courts in such actions, since irrespective of what standard was applied, there was an absence of "any allegation of injury which was caused by the proxy violations . . ." (App. 4a).* It dismissed the other claims on two independent grounds: (1) since the basic claim under the proxy rules could not be sustained, "the 10(b) claim must also fall for want of the necessary causal connection" (App. 5a); and (2) these counts, in any event, contained "only conclusory allegations without any specific allegations of fraud or deception, as required to support a 10(b) claim" (App. 5a).

The Court of Appeals reversed, holding, as to the proxy statement claim, that "a strict causation rule" was "antithetical" to the "purposes" of the securities acts (App. 16a). In apparently dispensing with the causation requirement, the Court held that "[c]ausation is a concept stemming from the law of torts, but we are here talking about the statutory purpose of the proxy rules" (App. 15a), finding that in this situation, "causation is satisfied by a material omission when there is a duty to disclose" (App. 15a-16a).

With respect to the Rule 10b-5 claim, the Court held that if there was any doubt as to whether this Rule applied to acts of corporate mismanagement not involving what has ordinarily been considered to be deception or misrepresentation, it had been "firmly interred" by this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), and that all that survived from prior contrary decisions was "the buyer-

* References in parentheses are to pages of the appendices.

seller requirement" (App. 12a). As regards causation, the Court, utilizing terminology which the concurring opinion found was "unnecessary" and had "uncertain implications" (App. 16a), held that it was not necessary under Rule 10b-5 to allege and prove what the Court called "transaction causation—that the violations in question caused the appellant to engage in the transaction in question" (App. 12a).

REASONS FOR GRANTING THE WRIT

I.

The decision on the Section 14(a) claim should be reviewed by this Court.

A. The particular proxy rules question decided herein is one of exceptional importance which has specifically been left open by this Court.

In holding that plaintiff has asserted an actionable Section 14(a) claim for damages in the absence of allegations of causation, the Court of Appeals has decided probably the single most important unresolved question in the proxy rules area—a question which this Court raised but expressly declined to determine in its most recent decision on proxy claims, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 385, n. 7 (1970).

This Court in *Mills* indicated that a basic question exists as to whether causation between alleged proxy violations and alleged damage could be shown "where the management controls a sufficient number of shares to approve the transaction without any votes from the minority" (396 U.S. at 385, n.7). The very fact that this Court has pin-pointed this specific issue, and found it too vexing to determine, attests to its singular importance in the development of

standards in this much-litigated area of law. As Professor Loss has observed, it is "apparent that causation has now become the critical question in this area." 5 L. Loss, *Securities Regulation* 2933 (Supp. to 2d ed. 1969).

We submit that this Court should now provide the much-needed guidance on this important issue which it withheld in *Mills* five years ago, particularly since the Court of Appeals has decided the question in a manner which is contrary to the fundamental principles of liability which have always been applied by this Court.

B. The present decision is in conflict with principles of causation which are fundamental to our jurisprudence and have long been recognized by this Court.

This Court has consistently recognized the basic, time-honored principles of causation which have long been applicable in cases arising under federal legislation, as well as in common law. Heretofore, in order for a cause of action for damages to be stated under a federal statute such as Section 14(a), a plaintiff has been required to allege and show a causal connection between the violation of that provision and his alleged injury, just as in an ordinary tort action arising under the common law.

Moreover, this requirement is far more than just a matter of technical pleading standards; in the absence of such a causal connection, an award predicated on a statutory violation which did not in fact produce any injury to plaintiff would be in essence a punitive fine or penalty intended to punish the defendant, rather than to compensate an injured plaintiff. Such a result would raise serious constitutional questions, for we fail to see how a party can be compelled to respond in damages where there is no causal connection between the alleged improper act and the

supposed damage. See, *e.g., Globe Liquor Co.* v. *Four Roses Distillers Co.*, 281 A.2d 19, 24 (Del. Sup. Ct.), *cert. denied*, 404 U.S. 873 (1971), where the Court, in holding a statutory provision unconstitutional when it provided for damages in the absence of actual loss, stated:

> ". . . the statutory damages, in the absence of any actual loss to the distributor, are not compensatory, but are in fact punitive. As such, they are the taking of private property without compensation and without due process of law."

Until now, the courts have not treated an implied private damage claim as giving rise to a recovery without the requisite causal nexus. Indeed, this Court has expressly held that compensation, not punishment, is the proper office of a private damage claim under the securities antifraud provisions. *Bangor Punta Operations, Inc.* v. *Bangor & Aroostook Railroad Co.*, 417 U.S. 703, 717 (1974) (discussed *infra* at pp. 11-12). As Prosser notes, "[t]he causal connection between the wrongful conduct and the resulting damage" is "essential throughout the law of torts". W. L. Prosser, *The Law of Torts* 714 (4th ed. 1971).

The instant ruling of the Court of Appeals constitutes a sharp and conceded departure from this principle; as the Court itself put it, "Causation is a concept stemming from the law of torts, but we are here talking about the statutory purpose of the proxy rules . . ." (App. 15a). The Court thus implied that causation, while ordinarily required in common law tort actions, is not necessarily a requisite in private actions predicated on federal statutory obligations such as Section 14(a). We respectfully submit that this has never been the case and that this Court has, indeed, uniformly held to the contrary.

Ever since this Court first found an implied private right of action for violation of a statute, a causal relationship between the claimed violation and the alleged injury has been recognized as a basic and indispensable element of an actionable damage claim. Thus, in *Texas & Pacific Railway* v. *Rigsby,* 241 U.S. 33, 39-40 (1916), the first case in which the Court enunciated such an implied right, it was held that a private remedy existed for a railroad employee where his injury was "directly attributable" to the railroad's violation of the Federal Safety Appliance Act. The Court, citing Blackstone's Commentaries and other authorities fundamental to our jurisprudence, stated:

> ". . . A disregard of the command of the statute is a wrongful act, and *where it results in damage* to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied . . ." 231 U.S. at 39-40. (Emphasis added.)

Similarly, the principle that an alleged statutory violation must "result in damage" to plaintiff in order to be the subject of a private damage claim has been uniformly recognized by this Court with respect to private actions under the securities antifraud provisions. Thus, in *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964), this Court's initial decision on private claims in this area, it was held that a minority stockholder stated a claim for damages under Section 14(a) by alleging that the merger there complained of had been approved "by a small margin of votes" and "would not have been approved but for the false and misleading statements in the proxy solicitation material" (*id.* at 430). In the presence of such unequivocal allegations of causation, the Court in *Borak* concluded that a federal cause of action was stated, and therefore that "the causal

relationship of the proxy material and the merger are questions of fact to be resolved at trial . . ." (*id.* at 431).*

Similarly, in its next decision in the area, *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), the Court, while expressly leaving open the specific question of causation presented here, clearly confirmed "the causation requirement" (396 U.S. at 385, n. 7), both by its explicit reference to the requirement, and by its framing of the question there presented:

> "The question with which we deal is what causal relationship must be shown between [an allegedly defective proxy] statement and the merger to establish a cause of action based on the violation of the Act." 396 U.S. at 377.

In *Mills*, the Court pointed out that the votes by proxy of "a substantial number of the minority shareholders" were there "necessary and indispensable to the approval of the merger" (396 U.S. at 379). Under such circumstances, the Court concluded that "petitioners have established their case by showing that the proxies *necessary to approval of the merger* were obtained by means of a materially misleading solicitation" (*id.* at 386, emphasis added), and that the Court of Appeals erred in "ruling that 'causation' may be negated by proof of the fairness of the merger" (*id.* at 382, n. 5).**

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* As District Judge (now Circuit Judge) Mansfield has pointed out, *Borak* "required that plaintiff demonstrate 'but for' causation, *i.e.*, that the corporate action would not have occurred in the absence of the alleged violation of the proxy rules." *Kaminsky* v. *Abrams*, 281 F. Supp. 501, 506 (S.D.N.Y. 1968).

** In the case at bar, it is conceded that plaintiff cannot show, and, indeed, does not even allege, that "proxies necessary to approval of the merger were obtained by means of a materially misleading solicitation." *Mills* v. *Electric Auto-Lite Co.*, *supra*, 396 U.S. at 386.

Nor do any of the post-*Borak* decisions concerned with implied private remedies under Rule 10b-5 provide any support for the abandonment of the causation requirement in private actions under the securities acts. Thus, in *Superintendent of Insurance of New York* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971), the Court pointed out that

> "The crux of the present case is that Manhattan suffered an injury *as a result of* deceptive practices touching its sales of securities as an investor. . . ." (Emphasis added.)

Similarly, in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972), the Court found that defendants had wrongfully

> "*induced* the mixed-blood holders of UDC stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell." (Emphasis added.)

Finally, in *Bangor Punta Operations, Inc.* v. *Bangor & Aroostook Railroad Company*, 417 U.S. 703, 717 (1974), this Court recently expressly reaffirmed the requirement of causation in actions under the securities acts, in rejecting the contention that liability should be imposed as a "deterrent to mismanagement" in the absence of damage to the particular plaintiff resulting from the alleged wrongs. The Court stated:

> ". . . If deterrence were the only objective, then in logic any plaintiff willing to file a complaint would suffice. No injury or violation of a legal duty to the particular plaintiff would have to be alleged. The only prerequisite would be that the plaintiff agree

> to accept the recovery, lest the supposed wrongdoer be allowed to escape a reckoning. Suffice it to say that we have been referred to no authority which would support so novel a result, and we decline to adopt it." (417 U.S. at 717.)

In sum, the law is clear that causation is as necessary in implied federal rights of action as it is in any other area of our jurisprudence. We respectfully submit that the Court of Appeals' suggestion to the contrary is in error, and that before such a departure from fundamental principles is made, it should be carefully examined by this Court.

C. The present decision is inconsistent with the legislative policy against the improper invocation of the securities laws.

It is apparent, moreover, that the present decision, in sanctioning a Section 14(a) claim for damages despite the lack even of a bare allegation that the challenged proxy statement caused plaintiff any injury, is in conflict with the legislative intent and policies underlying the securities acts.

Thus, the Senate Report regarding the 1934 Act clearly recognized the need "to give protection against 'strike' suits, or litigation brought in bad faith" (S. Rep. No. 792, 73rd Cong., 2d Sess. 18 (1934)), a need which is far more pressing today, in view both of the "rising caseload of the federal courts" * and the expanded availability of class actions under Rule 23, F. R. Civ. P.

Moreover, the present decision is in direct conflict with Section 28(a) of the 1934 Act, which expressly provides that liability in actions brought under the Act is limited to

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* *Snyder* v. *Harris*, 394 U.S. 332, 340 (1969).

such damages as are actually caused by the violation claimed:

> ". . . no person permitted to maintain a suit for damages under the provisions of [this act] shall recover . . . a total amount in excess of his *actual damages on account of the act complained of* . . ." (Emphasis added.)

This Court has made it clear that the existence and parameters of "a private cause of action not otherwise authorized by statute must be consistent with the evident legislative intent" (*National Railroad Passenger Corp.* v. *National Association of Railroad Passengers*, 414 U.S. 453, 457-458 (1974)). The present decision is plainly inconsistent with the "evident legislative intent" as manifested by Section 28(a).

D. The present decision is contrary to the determinations of a majority of the courts that have considered this question.

As the Court of Appeals' opinion indicates (App. 10a, n. 7), the Section 14(a) question presented here has been the subject of numerous District Court decisions. A review of these decisions shows that the result reached here is contrary to the post-*Mills* decisions of District Courts in other Circuits, see *Ross* v. *Longchamps, Inc.*, 336 F. Supp. 434 (E.D. Mo. 1971); *Krafcisin* v. *LaSalle Madison Hotel Co.*, CCH Fed. Sec. L. Rep. ¶ 93,586 (N.D. Ill. 1972), and, indeed, is contrary to the views of a majority of the District Judges in the Second Circuit who have considered the problem. See *Hanover* v. *Zapata Corp.*, CCH Fed. Sec. L. Rep. ¶ 93,904, at page 93,626 (S.D.N.Y. 1973), *appeal dismissed*, Docket Nos. 73-1166, 73-1476, 73-1477 (2d Cir.

1973); *Hanover* v. *Zapata Corp.*, CCH Fed. Sec. L. Rep. ¶ 93,905, at page 93,631 (S.D.N.Y. 1973), *appeal dismissed*, Docket Nos. 73-1166, 73-1476, 73-1477 (2d Cir. 1973); *Weiss* v. *Sunasco Inc.*, 295 F. Supp. 824 (S.D.N.Y. 1969); *Adair* v. *Schneider*, 293 F. Supp. 393 (S.D.N.Y. 1968); *Hoover* v. *Allen*, 241 F. Supp. 213, 231-232 (S.D.N.Y. 1965); *Barnett* v. *Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965); see also, *Smith* v. *Murchison*, 310 F. Supp. 1079 (S.D.N.Y. 1970); *Kaminsky* v. *Abrams*, 281 F. Supp. 501, 506 (S.D. N.Y. 1968); *Cohen* v. *Colvin*, 266 F. Supp. 677, 685 (S.D. N.Y. 1967); *Fields* v. *Baltimore & Ohio Ry. Co.*, CCH Fed. Sec. L. Rep. ¶ 91,872 (S.D.N.Y. 1967); *Robbins* v. *Banner Industries, Inc.*, 285 F. Supp. 758 (S.D.N.Y. 1966). But *cf. Laurenzano* v. *Einbender*, 264 F. Supp. 356 (E.D.N.Y. 1966), *ultimate judgment for defendants affirmed at* 448 F.2d 1 (2d Cir. 1971); *Heyman* v. *Heyman*, 356 F. Supp. 958 (S.D.N.Y. 1973); *Weber* v. *Bartle*, 272 F. Supp. 201 (S.D.N.Y. 1967).

Moreover, the present decision is in conflict with the views expressed in the only other case on the question that we have found which has been decided by another Circuit Court, *Swanson* v. *American Consumers Industries, Inc.*, 475 F.2d 516 (7th Cir. 1973),* where the Court, in *dictum*, pointed out that:

> "Insofar as plaintiff claims the merger itself was the injury [the claim also made by plaintiff in the present case], it may be that since ACI controlled a sufficient amount of shares to approve the merger regardless of the minority vote, causation between the deception and the injury has not been established . . ." (475 F.2d at 518).

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* A prior decision in *Swanson* is reported at 415 F.2d 1326 (7th Cir. 1969).

The Court in *Swanson* sustained the complaint *only* as to shareholders who had suffered the "loss of their informed ability to exercise their statutory appraisal rights" (475 F.2d at 521)—a factor concededly not present in the instant case.*

Thus, we have here the classic need to resolve conflicting views among courts throughout the country on an important issue of law, a need which has singular significance here since Section 14(a) claims are typically asserted in representative actions, in which the court determines the rights of thousands of stockholders residing in various states. Therefore, if the conflicts are not resolved, there will be variations in results not only among the Circuits, but also on a case to case basis among residents of the same area.

E. The present decision goes far beyond even the minority of prior District Court decisions expressing a more expansive view of causation.

Even the cases cited by the Court of Appeals in the present case, and by this Court in *Mills*, which have allowed a complaint to stand although the merger could have been consummated irrespective of the allegedly false proxy statement, have done so only when the false proxy statement may have caused plaintiff to forego other rights with respect to the merger—either the right to seek injunctive

* See also, *Dasho* v. *Susquehanna Corp.*, 461 F.2d 11, 30 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972), where the Court, in finding an actionable Section 14(a) claim, pointed out that, "Apart from the [proxy] solicitation, there is no contention that defendants could have mustered the necessary two-thirds vote required for approval of the merger."

relief against the merger or to prevent it through publicity or other extrajudicial means, or the opportunity to invoke statutory appraisal rights. For example, *Laurenzano* v. *Einbender*, 264 F. Supp. 356 (E.D.N.Y. 1966), cited by this Court in *Mills*, was an action instituted *after* the transactions in question had been consummated, where it was claimed that a false proxy statement misled plaintiffs into foregoing injunctive action or setting into motion extralegal procedures which might "have brought about modification or reconsideration of the transactions" (264 F. Supp. at 361). Similarly, in *Swanson* v. *American Consumer Industries, Inc.*, 475 F.2d 516 (7th Cir. 1973), as noted, the complaint was sustained only as to shareholders who had been induced to forego their appraisal rights.

Thus, these cases still uphold the causation requirement, although they give it a somewhat different content than the majority of cases. But the present decision, where there are no such claims, and where plaintiff voluntarily chose not to seek injunctive or other relief against the merger,* would effectively dispense with this requirement altogether—as indicated by the Court's comment that "causation is satisfied by a material omission when there is a duty to disclose." (App. 15a-16a).

This, we submit, is no causation at all; since there is always a "duty to disclose," the Court may be sanctioning recovery merely upon proof of a defective proxy statement, although the transaction in question would have been consummated irrespective of these defects. Any such rule would amount to a species of strict liability which has no

* This factor is of more than passing significance, since if plaintiff had sought such relief, and the Court had found the proxy statement to be misleading, plaintiff and all of the shareholders would have had the benefit of fully accurate proxy material.

precedent in this Court's decisions and is at variance with the fundamental principles underlying our jurisprudence. We respectfully submit that it should only be imposed after careful review and consideration by this Court.

II.

The present decision eliminates the requirement of fraudulent and deceptive conduct which has always been a prerequisite for liability under Rule 10b-5.

The decision of the Court of Appeals effects an unprecedented and unwarranted expansion of Rule 10b-5 to encompass conduct never before considered to be within its ambit. In effect, the present decision permits a plaintiff to use the conclusory label "scheme" to convert *any* type of challenged managerial conduct into federally cognizable securities fraud, even where the challenged managerial conduct does not involve any elements of deception or misrepresentation.*

This is done in the name of this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), where it was held that it was not "sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'" (404

* The particular claims made, all of which are alleged in the most conclusory of terms without any factual particulars, and which do not remotely concern any securities transaction involving plaintiff, are, in essence (a) that Penn-Dixie has used unspecified bank account balances of Continental as compensating balances for Penn-Dixie's borrowings; (b) that Continental entered into an unspecified Florida real estate transaction with an unspecified customer of Penn-Dixie in which Continental "may have actually incurred a loss"; (c) that Penn-Dixie has charged unspecified "excessive inter-company costs" to Continental; (d) that the method of accounting for Continental's inventories was changed from average cost to last-in, first-out; and (e) that the Continental pension fund made unspecified purchases of common stock of Penn-Dixie.

U.S. at 10-11, n. 7). But neither *Bankers Life* nor any other decision of this Court has done away with the requirement that there must be what has been consistently defined as fraudulent or deceptive conduct, rather than acts of corporate mismanagement such as are alleged here.

Thus, this Court in *Bankers Life* found an actionable 10b-5 claim to be stated when it was alleged that plaintiff was "*duped* into believing that it, the seller, would receive the proceeds" of a securities transaction, and was thereby "injured as an investor through a deceptive device" (404 U.S. at 9-10, emphasis supplied). The Court made it clear, however, that the requirement of deceptive conduct was not to be impaired, and that the Rule was not to be extended to cover acts of corporate mismanagement:

> "We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face." (*Id.* at 12.)

See also, *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972) (there was a "fraud upon Indian sellers" where "defendants devised a plan and induced [them] to dispose of their shares without disclosing to them material facts").*

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* Courts of Appeals of other Circuits have made it clear that misrepresentation or deception, rather than corporate mismanagement or unfairness, must be shown in order to state a claim under Rule 10b-5. See, *e.g.*, *Review 71* v. *Alloys Unlimited, Inc.*, 450 F.2d 482 (10th Cir. 1971); *Kellman* v. *ICS, Inc.*, 447 F.2d 1305, 1309 (6th Cir. 1971); see also, *Popkin* v. *Bishop*, 464 F.2d 714 (2d Cir. 1972); *O'Neill* v. *Maytag*, 339 F.2d 764 (2d Cir. 1964).

Bankers Life has spawned endless commmentary, and, we submit, has now been diverted into channels which were never intended by this Court. Under the present decision, a plaintiff need only paste the conclusory label of "scheme" on alleged conduct which has always been outside the ambit of the securities acts in order to open the doors to the federal courts. When, as in the present case, hundreds of thousands of shares of stock are involved, a plaintiff is thereby able to use federal class action jurisdiction as a vehicle for what one court has termed "legalized blackmail,"* in which the cost of defending even a completely meritless suit may be prohibitive. We respectfully submit that review by this Court is necessary to prevent this, and to clarify the scope of its decision in *Bankers Life*.

CONCLUSION

The present decision presents vital issues in two critical and much-litigated areas of the securities laws. In both areas, it departs from fundamental principles in a manner that should be reviewed by this Court. For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 12, 1975

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* *Eisen* v. *Carlisle & Jacquelin*, 479 F.2d 1005, 1019 (2d Cir. 1973), *vacated and remanded on other grounds*, 417 U.S. 156 (1974).

APPENDIX A

Opinion of the United States District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 1467

(Entered September 26, 1973)

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of CONTINENTAL STEEL CORPORATION similarly situated,

Plaintiff,

against

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, DANIEL H. ESCHEN, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, OLIVER K. PARRY, PAUL WINDELS, JR., GEORGE C. GREEN, ERIC M. JAVITS, JAMES F. MORRILL,

Defendants.

METZNER, *D. J.*,

Penn-Dixie Corporation (Penn-Dixie) and some of the individual defendants have moved to dismiss the complaint for failure to state a claim upon which relief may be granted. Rule 12(b)(6), Fed. R. Civ. P.

This is an action for damages for alleged violations of the federal securities law. It was instituted by the minority shareholders of Continental Steel Corporation (Continental) "on behalf of all present shareholders of Continental similarly situated." The facts giving rise to this litigation grew out of a proposed merger of Continental

into a wholly-owned subsidiary of Penn-Dixie. This merger had been proposed by the boards of directors of these two corporations in March 1973. By that time, Penn-Dixie had acquired the majority of the stock of Continental. In addition, several of the individual defendants in this lawsuit served on the boards of directors of both companies.

As a result of the proposal to merge, a proxy statement was sent to the plaintiff shareholders on March 29, 1973 seeking approval of the merger. Under the terms of the merger, Continental shareholders were to receive Penn-Dixie shares in exchange for Continental stock to be surrendered. On April 5, 1973 this action was commenced seeking only damages. No injunctive relief to enjoin the proposed merger was sought prior to the consummation of the merger on May 11, 1973.

The nub of the complaint is that the defendants engaged in a course of dealing which resulted in an unfair exchange ratio to the holders of the Continental stock. A cause of action is claimed in Count 2 of the complaint under Section 14(a) of the Securities Act of 1933 and Rule 14a-9 promulgated thereunder, in that the proxy statement issued in connection with the merger failed to disclose the defendants' scheme to make the exchange ratio more favorable to Penn-Dixie. Count I is alleged to state a cause of action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, in that the defendants embarked upon a scheme to create an unfair exchange ratio in connection with the sale of securities. The remaining two counts in the complaint contain common law allegations of corporate mismanagement and breach of fiduciary duty.

In support of their motion to dismiss, defendants claim that plaintiffs have failed to state a federal cause of action. Turning first to the alleged proxy violations, defendants

urge that because Penn-Dixie, as the majority shareholder of Continental, had the votes necessary to approve the merger, without obtaining any minority votes, there is no causal connection between the alleged proxy violations and the alleged injury, and, therefore, a claim for damages for proxy fraud cannot stand.

In support of this proposition, defendants rely on a series of cases in this district commencing with *Barnett* v. *Anaconda Co.*, 238 F. Supp. 766 (S.D.N.Y. 1965), which held that in a situation where a corporation owns sufficient stock to effect the transaction without the votes of the minority shareholders, any misleading statements in a proxy sent to the minority holders are immaterial and there is no federal cause of action. *See, Hanover* v. *Zapata Corp.*, CCH Fed. Sec. L. Rep. ¶ 93, 904 (S.D.N.Y. March 16, 1973); *Weiss* v. *Sunasco, Inc.*, 295 F. Supp. 824 (S.D.N.Y. 1969); *Andair* v. *Schneider*, 293 F. Supp. 393 (S.D.N.Y. 1968); *Robbins* v. *Banner Industries, Inc.*, 285 F. Supp. 758 (S.D.N.Y. 1966); *Hoover* v. *Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965).

The Court in *Barnett* reasoned that in such a situation:

> "The 'but for' element—the element of causation—does not and, indeed, could not exist. The transactions under attack did not result from the issuance of the allegedly misleading proxy material which, in view of the affirmative and concededly true allegation as to Anaconda's 73% stock holdings, could not have had anything to do with the approval and consummation of such transactions." (238 F. Supp. at 771.)

Plaintiffs, however, point out that there is a competing line of cases beginning with *Laurenzano* v. *Einbender*, 264 F. Supp. 356 (S.D.N.Y. 1966), *aff'd*, 419 F.2d 1 (2d Cir.

1967), which would sustain their claim under Count II. *See, Heyman* v. *Heyman,* CCH Fed. Sec. L. Rep. ¶ 93, 924 (S.D.N.Y. March 27, 1973); *Weber* v. *Bartle,* 272 F. Supp. 201 (S.D.N.Y. 1967); *Globus* v. *Jaroff,* 271 F. Supp. 378 (S.D.N.Y. 1967).

In *Laurenzano,* the Court refused to follow *Barnett,* holding that the complaint stated a good cause of action under Section 14(a) because it could not be "assumed without evidence that the solicitation of proxies was a gratuitious and, therefore, purposeless and legally inert act."

The Supreme Court in *Mills* v. *Electric Autolite Co.,* 396 U.S. 375 (1970), has specifically left open the question of "whether causation could be shown where the management controls a sufficient number of shares to approve the transaction without any votes from the minority." 396 U.S. at 385, n. 7.

On the facts of this case, this court need not choose between *Barnett* or *Laurenzano.* Both cases assume that causation has to be shown, between the alleged violation of Section 14(a) and the alleged damage, in order to make out a federal claim.

The deficiency in the instant complaint stems from the absence of any allegation of injury which was caused by the proxy violations, aside from that claimed to flow from the unequal ratio. In *Laurenzano,* however, the complaint alleged protective actions that plaintiff might have taken except for the alleged misleading proxy statement. *Cf.. Rosenblatt* v. *Northwest Airlines, Inc.,* 435 F.2d 1121, 1124 (2d Cir. 1970); *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F.2d 540, 546-47 (2d Cir. 1967); *Popkin* v. *Bishop,* 468 F.2d 714, 718 (2d Cir. 1972).

Furthermore, plaintiffs have failed to allege any other rights that were lost by defendants' actions, such as ap-

praisal rights under state law which might be compensated for under Section 14(a), even if their shares were not necessary to the consummation of a proposed transaction. *See, Rosenblatt* v. *Northwest Airlines, Inc., supra, Swanson* v. *American Consumers Industries, Inc.*, 475 F.2d 516, 520 (7th Cir. 1973). Similarly, this complaint has not alleged that as a result of the misleading proxy, plaintiffs forfeited other rights or opportunities which would be sufficient to establish a Section 14(a) claim. *Cf., Gerstle* v. *Gamble-Skegmo,* F.2d (2d Cir. May 9, 1973) at 3444. Consequently, Count II must be dismissed.

Turning briefly to Count I of the complaint which purports to allege a violation of Section 10(b), plaintiffs have conceded that if their basic claim under the proxy rules cannot be sustained, the 10(b) claim must also fall for want of the necessary causal conection. *See, e.g., Haberman* v. *Murchison,* 468 F.2d 1305 (2d Cir. 1972). Even apart from this causation requirement, however, this count is defective because it contains only conclusory allegations without any specific allegations of fraud or deception, as required to suport a 10(b) claim. *See, e.g., Segal* v. *Gordon,* 467 F.2d 602, 607 (2d Cir. 1972); *O'Neill* v. *Maytag,* 339 F.2d 764, 767-68 (2d Cir. 1964). Therefore, Count I must also be dismissed.

Inasmuch as plaintiffs' federal claims have been dismissed, there is no basis for retaining the common law claims alleged in Counts III and IV under the doctrine of pendent jurisdiction. *United Mine Workers* v. *Gibbs,* 383 U.S. 715 (1966).

So ordered.

CHARLES M. METZNER
U.S.D.J.

Dated: New York, N. Y.
September 26, 1973

APPENDIX B

Majority Opinion and Concurring Opinion of the United States Court of Appeals

John SCHLICK, Plaintiff-Appellant,

v.

PENN-DIXIE CEMENT CORPORATION et al., Defendants-Appellees.

No. 1069, Docket 73-2077.

United States Court of Appeals, Second Circuit.

Argued Aug. 13, 1974.

Decided Oct. 31, 1974.

Action by stockholder of corporation, seeking to recover damages under the securities laws, which claims allegedly arose in connection with a merger. The United States District Court for the Southern District of New York, Charles M. Metzner, J., dismissed the complaint for failure to state a claim upon which relief could be granted, and stockholder appealed. The Court of Appeals, Oakes, Circuit Judge, held that allegations made under statutes relating to deceptive and manipulative devices, and to proxies, were sufficient to overcome motion to dismiss.

Reversed and remanded.

Frankel, District Judge, concurred and filed opinion.

1. Federal Civil Procedure ⇐636

While allegations of fraud based on information and belief usually do not satisfy the degree of particularity required by federal rule relating to pleading special matters, the particularity requirement may be satisfied if the allegations are accompanied by a statement of the facts upon which the belief is founded. Fed.Rules Civ.Proc. rule 9 (b), 28 U.S.C.A.

2. Federal Civil Procedure ⇐678

Rule relating to information and belief may be relaxed as to matters peculiarly within opposing party's knowledge, as in the situation where complaining stockholders in a derivative suit have little information about the manner in which the corporation's internal affairs are conducted and hence cannot provide details as to an alleged fraud. Fed.Rules Civ.Proc. rule 9, 28 U.S.C.A.

3. Federal Civil Procedure ⇐621

Rule relating to pleading special matters must be construed in conjunction with rule relating to the general rules of pleading. Fed.Rules Civ.Proc. rules 8, 9, 28 U.S.C.A.

4. Federal Civil Procedure ⇐651

A complainant is not required to plead evidence.

5. Securities Regulation ⇐136

Rule relating to pleading special matters was sufficiently complied with in action alleging violations of the securities laws, arising out of a merger, where, inter alia, complaint specifically alleged that pension fund of stockholder's corporation was used to purchase common stock of merging corporation on the market in order to create a higher price for shares of merging corporation, which higher price was utilized to obtain an exchange ratio more favorable

to merging corporation. Fed.Rules Civ. Proc. rule 9, 28 U.S.C.A.

6. Securities Regulation ⇐118, 131

Assertions that misconduct complained of "really" amounts to "just" corporate mismanagement will not cut off an injured party's remedy under the federal securities laws; where Securities Exchange Commission rule governing disclosure required in connection with sale or purchase of securities properly extends it will be applied regardless of any cause of action that may exist under state law. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

7. Securities Regulation ⇐143

In a misrepresentation case involving securities statute relating to manipulative and deceptive devices, to show "transaction causation" a plaintiff must demonstrate that he relied on the misrepresentation in question when he entered into the transaction which caused him harm. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

See publication Words and Phrases for other judicial constructions and definitions.

8. Securities Regulation ⇐143

In an omission or nondisclosure case based upon Securities Exchange Commission rule relating to manipulative and deceptive devices, a plaintiff need not show reliance in order to show transaction causation, but must still show that the facts in question are material in the sense that a reasonable investigator might have considered them important in making his investment decision. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

9. Securities Regulation ⇐141

Under count involving manipulative and deceptive devices, contained in complaint alleging violation of the securities laws, proof of transaction causation was unnecessary by virtue of allegations as to the effectuation of a scheme to defraud, which included market manipulation and a merger on preferential terms, of which the proxy omissions and misrepresentations were only one aspect, so that plaintiff need only show loss causation with respect to his claim for relief. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b).

10. Federal Civil Procedure ⇐1269

Complaint alleging violation of securities statute relating to manipulative and deceptive devices, arising out of merger, sufficiently alleged that, as a result of the merger, plaintiff stockholder was forced to sell shares in his corporation to merging corporation on the basis of an exchange ratio that reflected adversely the manipulated market value of stockholder's stock, and that he sustained injury accordingly, which allegation was sufficient to overcome motion to dismiss complaint for failure to state a claim upon which relief could be granted. Securities Exchange Act of 1934, § 10(b), 15 U.S.C.A. § 78j(b); Fed.Rules Civ. Proc. rule 12(b)(6), 28 U.S.C.A.

11. Securities Regulation ⇐136

Both types of causation must be shown in order to state a claim under section of securities laws relating to proxies; transaction causation, in order to show violation of the law from which plaintiff may recover, and loss causation, in order to show damages. Securities Exchange Act of 1934, § 14(a), 15 U.S.C.A. § 78n(a).

12. Securities Regulation ⇐136

Causality was sufficiently pleaded, in action by stockholder alleging violation of securities laws regarding proxies, arising out of merger of stockholder's corporation with another corporation, where stockholder plainly alleged loss causation or economic loss on grounds that there was an unequal, unfair and disadvantageous merger ratio, and nondisclosure of proxy materials, by which he obtained fewer of merging corporation's shares and warrants than he would have had if merging corporation's manipulative scheme had been revealed. Securities Exchange Act of 1934, § 14(a), 15 U.S.C.A. § 78n(a).

13. Securities Regulation ⇐132

Fact that stockholder, who brought action alleging violation of the securities

laws arising out of a merger, failed to seek an injunction did not preclude stockholder from recovery, where stockholder could have felt that in the end an injunction would cost everyone more money and create greater problems for all, or where stockholder might have been required to post a bond for damages and been unable to pay the premium.

14. Securities Regulation ⇐50, 61

Minority shareholders aside, there are two other purposes served by the disclosure requirements which makes the strict causation rule, whether under statute relating to manipulative and deceptive devices, or under statute relating to proxies, antithetical to it; by disclosure the market will be informed, so as to permit well-based decisions about buying, selling and holding the securities involved in the transaction, and by virtue of the disclosure either modification or reconsideration of the terms of the merger by those in control might be effectuated. Securities Exchange Act of 1934, §§ 10(b), 14(a), 15 U.S.C.A. §§ 78j (b), 78n(a).

Jeffrey L. Zivyak and Ira W. Berman, New York City, for plaintiff-appellant.

Marc P. Cherno, New York City (Joseph H. Einstein, Alan J. Russo, New York City, of counsel), for defendants-appellees.

Amicus Brief filed by S. E. C. (Lawrence E. Nerheim, Gen. Counsel, Walter North, Associate Gen. Counsel, Frederic T. Spindel, Sp. Counsel, Frederick B. Wade, Atty., Securities and Exchange Commission, Washington, D. C.).

Before OAKES, Circuit Judge, and FRANKEL and KELLEHER, District Judges.*

OAKES, Circuit Judge:

This appeal is from a judgment dismissing a complaint for failure to state a claim upon which relief may be granted under Fed.R.Civ.P. 12(b)(6). The action is one for damages for alleged violations of the federal securities laws,[1] brought by a minority shareholder[2] of Continental Steel Corporation (Continental), an Indiana corporation listed on the New York Stock Exchange (NYSE). The alleged violations arose in connection with a merger of Continental into a wholly owned subsidiary of defendant Penn-Dixie Cement Corporation (Penn-Dixie), also listed on the NYSE.

The dismissed complaint alleges that between October, 1967, and October, 1969, Penn-Dixie acquired 1,111,514 shares or approximately 52.9 per cent of the outstanding common stock of Continental. Having thus acquired voting control over Continental, Penn-Dixie instituted management control over the corporation by placing six of its directors and officers on Continental's nine member board of directors. Appellant claims that Penn-Dixie then exercised its control of Continental so as to defraud Continental shareholders.

Generally, Penn-Dixie is said to have manipulated and depressed the market value of Continental stock in relation to that of Penn-Dixie by utilizing Continental's assets for the benefit of Penn-Dixie and to have caused Continental to enter into a merger agreement providing for an unfair exchange ratio based upon manipulated and artificial stock values of the merging parties. On March 14, 1973, the boards of directors of both companies unanimously approved an agreement of merger[3] by which Continental shareholders would receive in exchange for each share of Continental

* Of the Southern District of New York and the Central District of California, respectively, sitting by designation.

1. Jurisdiction is based upon Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa (1970), which gives to the district courts jurisdiction over actions brought to enforce any liability or duty under the act irrespective of the amount in controversy or the citizenship of the parties.

2. Appellant Schlick sues for himself individually and on behalf of all purchasers of Continental similarly situated. Appellees include Penn-Dixie and several officers and directors of both Penn-Dixie and Continental.

3. Since under Indiana law, a majority vote of the outstanding shares of a corporation is sufficient to secure shareholder approval of a merger, Burns, Ind.Stat.Ann. Title 23, art. I, ch. 5, § 2(b) (1972), and since Penn-

one and one-half shares of Penn-Dixie common stock and a warrant[4] to purchase an additional share of Penn-Dixie. In connection with the merger the complaint further alleges that Penn-Dixie issued a materially defective proxy statement which failed to disclose the manner in which Penn-Dixie had inflated the value of its shares at the expense of Continental. Damages claimed are in an indeterminate amount set at no less than $10 per Continental share, representing the difference in value between the value of the Continental shares in the actual merger and what they would have been worth but for the manipulations of Penn-Dixie.

On the basis of these general obligations, the complaint contains four claims of relief, in separate counts. The first alleges a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), and Rule 10b–5 promulgated thereunder, 17 C.F.R. § 240.10b–5 (1974); count two claims a violation of the proxy solicitation provision of Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1970), and Rule 14a–9 thereunder, 17 C.F.R. § 240.14a–9 (1974); the third and fourth counts of the complaint are common law counts based upon fraud and unfairness, each of which is pendent to the federal claims. Thus the whole complaint must fail unless one of the federal counts is viable. United Mine Workers v. Gibbs, 383 U.S. 715, 86 S.Ct. 1130, 16 L.Ed.2d 218 (1966).

The district court found that the proxy count of the complaint was defective in that it failed to present "any allegation of injury which was caused by the proxy violations, aside from that claimed to flow from the unequal ratios." Schlick v. Penn-Dixie Cement Corp., No. 73, Civ. 1467 (S.D.N.Y., decided Sept. 26, 1973). In effect, the district court seemed to be saying that the appellant failed to show that the appellees' misstatements or omissions contributed to the kind of injury which the federal securities laws were intended to redress.[5]

In reaching this conclusion, the district court relied heavily on the fact that the allegedly false and misleading proxy statement did not cause Continental minority stockholders any harm other than that caused by the unfair exchange ratio. They were not misled about their rights so as to have failed to take protective action in the form of seeking injunctive relief; rather, the court below continued, appellant chose to bring this action for damages before the merger was finalized. Nor did the complaint allege that other rights such as appraisal rights were lost as a result of appellees' action.[6] On such a showing, the district court regarded the appellant's proxy claim as one based upon what was alleged merely

Dixie possessed that majority, the merger was consummated on May 11, 1973, while this suit was pending.

4. This exchange ratio was "arrived at by considering, among other factors, the earnings prospects, book values, and the market prices of the common stock of both companies" (Joint Proxy Statement at 3). Each warrant entitles the holder to purchase one share of Penn-Dixie common stock for $8 per share through May 1, 1978, and for $11 per share thereafter until an expiration date of May 1, 1983.

5. It is unclear whether the district court reached the issue of causation in dismissing the case. One reading of the opinion would suggest that the district court felt that the element of causation was lacking in the appellant's proxy count. Another reading would indicate that the claim was dismissed because the only kind of injury which appellant claimed was economic injury based on the unfair merger ratio, and that the district court perceived this kind of injury to be a matter for the state courts, beyond the reach of the federal securities laws.

6. Under Indiana law minority stockholders are not entitled to the appraisal rights generally otherwise afforded, since here the company's shares are traded on the NYSE. Burns, Ind.Stat.Ann. Title 23, art. 1, ch. 5, § 7 (1972). The rationale of this statutory exception may well be that appraisal rights are not necessary where the shares of dissenting shareholders can be readily sold at a fair market price. But here, if the appellant's allegations are true, the purpose of the appraisal statute was thwarted as the market price of Continental shares had been manipulated so as not to reflect their true value.

to be an unfair merger. While conceding this might well state a cause of action under state law, Judge Metzner rejected the argument that a federal claim could be maintained.[7]

The dismissal by the court below of appellant's 10b–5 count was based first upon what the district court said was a concession by the appellant that if his "basic claim under the proxy rules cannot be sustained, the 10b claim must also fall for want of the necessary causal connection" and secondly upon a determination that the count was defective because it contained "only conclusory allegations without any specific allegations of fraud or deception as required to support a 10(b) claim." Segal v. Gordon, 467 F.2d 602, 607 (2d Cir. 1972); O'Neill v. Maytag, 339 F.2d 764, 767–768 (2d Cir. 1964).[8] We disagree with the district court on its dismissal as to each of the federal act claims and hence reverse, for reasons stated below.

I. THE RULE 10b–5 CLAIM.

[1–5] A. *The sufficiency of the complaint.* We go first to the 10b–5 count of the complaint. That count does allege generally "the engagement in a course of business which operated as a fraud and deceit on the purchasers and holders of Continental stock." If that were all that were alleged, it would fall within this court's rule that "mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b–5 are insufficient." Segal v. Gordon, 467 F.2d at 607, *quoting* Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 444 (2d Cir. 1971), and O'Neill v. Maytag, *supra*. But here the complaint contains more than conclusory allegations. Paragraph 15 specifically alleges that Continental bank accounts were utilized by Penn-Dixie as compensating balances for Penn-Dixie's own borrowings and for Penn-Dixie's benefit without compensation or benefit to Continental, thereby depriving Continental of its ability to use its own capital to expand its business and thereby obtaining a more favorable merger exchange ratio. The same paragraph specifically alleges that Continental funds were utilized by Penn-Dixie to engage in a real estate venture in Florida with a "special customer" of Penn-Dixie, for the benefit of Penn-Dixie and without compensation to Continental for the use of its funds. The complaint alleges the charging of excessive intercompany costs to Continental, thus reducing Continental's income and increasing that of Penn-Dixie. It alleges an accounting change,

7. In so holding, the district judge indicated that he did not have to choose between the two competing lines of cases within this circuit on the question whether causation can be shown where the management controls enough votes to approve a transaction without the assent of the minority. This question was specifically left open by the Supreme Court in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 n. 7, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970). It has been answered affirmatively by some district courts, headed by Laurenzano v. Einbender, 264 F.Supp. 356 (E.D.N.Y.1966), and its progeny Heyman v. Heyman, 356 F.Supp. 958, 967–968 (S.D.N.Y.1973) and Weber v. Bartle, 272 F. Supp. 201 (S.D.N.Y.1967). Other district courts have, however, found causation lacking in such a factual setting. *See* Barnett v. Anaconda Co., 238 F.Supp. 766 (S.D.N.Y. 1965), and the cases following its line of reasoning: Hanover v. Zapata Corp., CCH Fed.Sec.L.Rep. ¶ 93,904 at 93,626 (S.D.N.Y. 1973); Weiss v. Sunasco, Inc., 295 F.Supp. 824 (S.D.N.Y.1969); Adair v. Schneider, 293 F.Supp. 393 (S.D.N.Y.1968); Robbins v. Banner Industries, Inc., 285 F.Supp. 758 (S.D.N.Y.1968); Hoover v. Allen, 241 F.Supp. 213 (S.D.N.Y.1965).

8. Segal v. Gordon, *supra*, rests on the language of Fed.R.Civ.P. 9(b) that "[i]n all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity." It is arguable, of course, that 9(b) relates only to common law fraud and in no way to SEC Rule 10b–5. The SEC Rule does refer to common law fraud in connection with the purchase or sale of a security in subsection 2, but it also illegalizes, in subsection 1, employing "any device, scheme, or artifice to defraud" and, in subsection 3, engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." *See* 3 A. Bromberg, Securities Law: Fraud § 11.8, at 264 (1973) (hereinafter Bromberg).

valuing certain Continental inventories on a last-in, first-out basis rather than average cost as had been done prior to 1971, thereby incurring a $595,000 special income charge reducing Continental's earnings for the year ending December 31, 1972, the year prior to merger. The complaint also alleges an over-inflation of Penn-Dixie assets by including in Penn-Dixie book value the sum of $21,425,000 which was the excess of cost over related net assets attributed to Penn-Dixie's purchase of the common stock of Continental.[9] Finally, it alleges that the appellees caused the Continental pension fund to purchase common stock of Penn-Dixie on the market in order to create a higher price for the shares of Penn-Dixie, which higher price was utilized to obtain an exchange ratio more favorable to Penn-Dixie. While all of these allegations are stated on information and belief, and there are cases holding that allegations of fraud based on information and belief usually do not satisfy the degree of particularity required by Fed.R.Civ.P. 9(b), Lee v. Alabama, 364 F.2d 945 (5th Cir. 1966); Duane v. Altenburg, 297 F.2d 515, 518 (7th Cir. 1962), the particularity requirement may be satisfied if, as here, the allegations are accompanied by a statement of the facts upon which the belief is founded. *Id.*; 5 C. Wright & A. Miller, Federal Practice and Procedure: Civil § 1298, at 416 (1969). Wright and Miller point out that the rule relating to information and belief may be relaxed as to matters peculiarly within the opposing party's knowledge, as where the complaining stockholders in a derivative suit have little information about the manner in which the corporation's internal affairs are conducted and hence are rarely able to provide details as to the alleged fraud. *Id.* In any event, Rule 9 must be construed in conjunction with Rule 8, *id.*; Carroll v. First National Bank of Lincolnwood, 413 F.2d 353 (7th Cir. 1969), cert. denied, 396 U.S. 1003, 90 S.Ct. 552, 24 L.Ed.2d 494 (1970), and a complainant is not required to plead evidence. Brady v. Games, 76 U.S.App.D.C. 47, 128 F.2d 754, 755 (1942); Collins v. Rukin, 342 F.Supp. 1282, 1292 (D.Mass.1972). We consider Rule 9 sufficiently complied with here.

[6] B. *The nature of the fraud.* It is well to put to rest, in the light of Judge Metzner's holding, a slow-to-die contention advanced by appellees principally in oral argument but to some extent in their brief—a contention first authoritatively set forth in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952), *viz.*, that § 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs. . . ." Here, appellees tell us, all that appellant is complaining about is "corporate mismanagement," and as such is in the wrong forum. As long ago as A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967), this *Birnbaum* proposition was no longer the law of this circuit as 10b–5 was there construed to include "*all* fraudulent schemes in connection with the purchase or sale of securities, whether . . . a garden type variety of fraud, or . . . a unique form of deception." While *Birnbaum* was principally relied upon in O'Neill v. Maytag, *supra*, which in turn was relied upon by the court below in terms of stating the restrictive view, the authority of these cases (*Birnbaum* and *O'Neill*) was, as stated by District Judge Moye in First American Corp. v. Foster, 51 F.R.D. 248, 251 (N.D.Ga.1970), "seriously undercut" by Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir.1968), rev'g, 405 F.2d 200, cert. denied, 395 U.S. 906, 89 S.Ct. 1747, 23 L.Ed.2d 219 (1969). Thus Judge Feinberg could write in Popkin v. Bishop, 464 F.2d 714, 718 (2d Cir. 1972), that "assertions by a defendant

9. The complaint alleges that if this $21,425,000 had been excluded, the actual book value of Penn-Dixie would have been approximately $16 per share, rather than the $23.12 as stated in the proxy materials.

that the misconduct complained of 'really' amounts to 'just' corporate mismanagement will not cut off a plaintiff's federal remedy. Where Rule 10b–5 properly extends, it will be applied regardless of any cause of action that may exist under state law." In any event, any lingering doubts as to the vitality of this *Birnbaum* proposition were firmly interred by the Supreme Court in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 10–11 n. 7, 92 S.Ct. 165, 168, 30 L.Ed.2d 128 (1971), when the Court stated that it is not 'sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'" [*quoting* A. T. Brod & Co. v. Perlow, 375 F.2d at 397] and that

> [t]he fact that the fraud was perpetrated by an officer of [the company] and his outside collaborators is irrelevant to our problem . . .
>
> * * * * * *
>
> We agree that Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face . . .

404 U.S. at 10–12, 92 S.Ct. at 168–169. It can thus truthfully be said as Professor Bromberg points out that "[a]fter *Supt. of Insurance*, then, *Birnbaum* survives significantly only for the buyer-seller requirement, which has been much reduced by other decisions." [10] 1 Bromberg § 4.7 (522), at 84.32.

We come then to the causation question, that is, whether the scheme which appellant alleges took place brought about the injury in fact. As we have said, it is difficult to tell whether Judge Metzner felt that this element of causation was lacking in view of his finding that the proxy violations in question—the misrepresentations and omissions of the appellees—did not cause a federally remediable injury to the appellant. Having thus disposed of the proxy count, Judge Metzner seemingly regarded the 10b–5 claim to be based on precisely the same operative facts, and for that reason dismissed it as well "for want of the necessary causal connection." We disagree with these conclusions.

[7, 8] This is not a case where the 10b–5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction causation*—that the violations in question caused the appellant to engage in the transaction in question.[11] The former is demonstrated rather easily by proof of some form of economic damage, here the unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more. In a misrepresentation case, to show transaction causation a plaintiff must demonstrate that he relied on the misrepresentations in question when he entered into the transaction which caused him harm. 2 Bromberg § 8.6, at 209–11. In an omission or nondisclosure case

10. To the extent that Segal v. Gordon, 467 F.2d 602 (2d Cir. 1972), and O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964), rely upon *Birnbaum* for the enunciation of their specificity requirements, Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971), leaves them without applicability to the case at hand. *See also* Jannes v. Microwave Communication, Inc., 461 F.2d 525, 528–530 (7th Cir. 1972).

11. In terms of transaction causation, other methods of conceptualising the same issue include the doctrines of reliance, materiality and the buyer-seller requirement. *See* 1 Bromberg § 4.7 (551), at 86; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238–240 (2d Cir. 1974). *See generally* Note, Causation and Liability in Private Actions for Proxy Violations, 80 Yale L.J. 107, 123–24 (1970).

based upon Rule 10b–5, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material "in the sense that a reasonable investigator might have considered them important" in making his investment decisions. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153–154, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972). *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 240 (2d Cir. 1974).

[9, 10] Under the 10b–5 count, proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms, of which the proxy omissions and misrepresentations are only one aspect.[12] Thus appellant need only show loss causation with respect to his claim for relief under 10b–5; Judge Metzner found and we agree that this has been shown. Here the complaint clearly alleges that, as a result of the merger, appellant was forced to sell his Continental shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated market value of Continental stock, and that he sustained injury accordingly.

It is not seriously argued that there is a failure to state a claim for relief because there was no "connection" under Rule 10b–5 between the misconduct and the security transaction here involved. Nor could there be, particularly in view of the specific allegation that defendants caused the Continental pension fund to purchase the common stock of Penn-Dixie in the market in order to create a higher price for Penn-Dixie shares and thus obtain a more favorable exchange ratio. In any event, Superintendent of Insurance v. Bankers Life & Casualty Co., *supra*, and our own Drachman v. Harvey, 453 F.2d 736 (2d Cir. 1972) (en banc), rev'g, 453 F.2d 722 (2d Cir. 1971), make it clear that the violations here alleged had a connection with the sale of Continental shares and purchase of Penn-Dixie shares effectuated by the merger. *See also* Vine v. Beneficial Finance Co., 374 F.2d 627, 635 (2d Cir.), cert. denied, 389 U.S. 970, 88 S.Ct. 463, 19 L.Ed.2d 460 (1967).

Thus, the complaint completes the showing necessary to state a claim under Rule 10b–5. It alleges a specific scheme to defraud (a scheme which includes the proxy solicitation as a part, but which included substantial collateral conduct as well); the fraud was accomplished in connection with a securities transaction; the appellant was a seller in that transaction; and as a result of the sale, appellant alleges a loss was sustained.

II. THE 14a–9 CLAIM.

[11] As to count two of the complaint based upon alleged proxy violations, as we have said, quite plainly appellant has alleged loss causation or economic loss in that there was an unequal, unfair and disadvantageous merger ratio, undisclosed in the proxy materials, by which he obtained fewer Penn-Dixie shares and warrants than he would have had the appellees' manipulative scheme been revealed. It is axiomatic that fewer shares are worth less on the open market than more shares, and while it is true that "damages should be recoverable only to the extent that they can be shown," Mills v. Electric Auto-Lite Co., 396 U.S. 375, 389, 90 S.Ct. 616, 624, 24 L.Ed.2d 593 (1970), the complaint alleges that appellant was the holder of 2,000 shares of Continental. Depending upon what the evidence shows in terms of damages, he might well have received in excess of the 3,000 shares of Penn-Dixie which he did in fact obtain had a fair exchange ratio been adopted. Therefore, we must immediately confront the issue whether the proxy violations themselves caused the transaction in question, the exchange.[13] Both types of causation

12. *See* 1 Bromberg § 4.7 (558–59), at 86.25, 86.32 (1973).

13. This is the question, as said, left undecided in Mills v. Electric Auto-Lite Co., 396

must be shown in order to state a Section 14(a) claim: transaction causation to show a violation of the law from which an appellant may recover, and loss causation to show damages.[14]

The premise underlying the strict view of transaction causation is that Penn-Dixie would have voted to proceed with the merger in any event, irrespective of any misstatements or omissions in the proxy. Even by dissenting to the merger minority stockholders of Continental could not have secured a higher price for their stock than the merger terms offered since under Indiana law, stockholders in a company listed on the NYSE have no appraisal rights. Burns, Ind. Stat.Ann. Title 23, art. I, ch. 5, § 7 (1972). The argument is in short that minority stockholders' votes must be viewed as meaningless since the insiders with a conflict of interest had enough votes to approve the transaction in any event.

This court has said, however, in affirming the second *Laurenzano* case, in which Judge Dooling found on the merits against the plaintiff that "[minority shareholder] approval was not meaningless; minority shareholder approval has value whether or not it is strictly essential to the power to act." Laurenzano v. Einbender, 448 F.2d 1, 5 (2d Cir. 1971). *See also* Lewis v. Bogin, 337 F. Supp. 331, 337 (S.D.N.Y.1972). As the Seventh Circuit said in Swanson v. American Consumer Industries, Inc., 415 F.2d 1326 (7th Cir. 1969) (*Swanson I*), "[t]he power to effect a given result certainly does not negative all possibility of injury resulting from the fraudulent or manipulative use of that power." *Id.* at 1331–1332. While one need not go so far perhaps as Judge Sprecher, dissenting and concurring in Swanson v. American Consumer Industries, Inc., 475 F.2d 516, 522 (7th Cir. 1973) (*Swanson II*), by saying that causation should be conclusively established by the mere solicitation of votes, in a very real sense the shareholders were deceived by the action of those making the corporate decision to merge. *Cf.* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797 (2nd Cir. 1969), cert. denied, 400 U.S. 822, 91 S.Ct. 41, 27 L.Ed.2d 50 (1970). *See also* Vine v. Beneficial Finance Co., 374 F.2d at 635.

We have previously said that a controlling shareholder's "ability to push through the merger—with or without any other shareholder's vote—cannot by itself defeat a claim for federal *injunctive* relief." Popkin v. Bishop, 464 F.2d at 718 (emphasis added) (but denying injunction since full disclosure was made). Again, as was recognised in Heyman v. Heyman, 356 F.Supp. 958, 967–968 (S.D.N.Y.1973), minority shareholders may "have recourse to measures other than the casting of proxies" to oppose those who have "the naked strength to consummate a fraudulent transaction." At least they are in a better position to protect their interests if they have full disclosure of the facts. *Cf.* Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 375 (2d Cir.), cert. denied, 414 U.S. 910, 94 S.Ct. 231, 38 L.Ed.2d

U.S. at 385 n. 7, 90 S.Ct. at 622, "whether causation could be shown where the management controls a sufficient number of shares to approve the transaction without any votes from the minority." It is not insignificant to note that the Court went on to say,

> Even in that situation, if the management finds it necessary for legal or practical reasons to solicit proxies from minority shareholders, at least one court has held that the proxy solicitation might be sufficiently related to the merger to satisfy the causation requirement.

Id. Without putting too much emphasis upon citations by the Supreme Court in footnotes, the Court then cited the first *Laurenzano* decision, Laurenzano v. Einbender, 264 F.Supp. 350, 360–362 (1965), and cited the strict view of causation taken in Barnett v. Anaconda Co., 238 F.Supp. 766, 771 (S.D.N.Y.1965), as a "*But see.*"

14. Mills v. Electric Auto-Lite Co., 396 U.S. at 377, 90 S.Ct. 616; J. I. Case Co. v. Borak, 377 U.S. 426, 431, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964). *But see* Note, Private Actions for Proxy Violations, 80 Yale L.J. 107, 124 n. 80 (1970).

148 (1973); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302–1303 (2d Cir. 1973).

[12] In the end we must remember the "broad remedial purposes" of the Securities Act. J. I. Case Co. v. Borak, 377 U.S. 426, 431, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963). Indeed, *Mills* itself, while leaving the question open, as we have pointed out, by holding that there was a sufficient causal relationship in a proxy case by proof that the proxy solicitation itself rather than the particular defect in the solicitation materials was an essential link in the accomplishment of the transaction, 396 U.S. at 385, 90 S.Ct. 616, lends some support to a more moderate view of transaction causation. Causality, we think, is sufficiently pleaded; the proof may, of course, be something else.

Causation is a concept stemming from the law of torts, but we are here talking about the statutory purpose of the proxy rules, a purpose which, as *Mills* itself pointed out, arises from Congressional belief in "fair corporate suffrage" to obtain which "explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." Congressional concern was specifically with conflict of interest transactions. Stock Exchange Practices, S. Rep.No.1455, 73d Cong., 2d Sess., 74–76 (1934). *See also* S.Rep.No.792, 73d Cong., 2d Sess., 12 (1934). Indeed, the addition in 1964 of Securities Exchange Act § 14(c), 15 U.S.C. § 78n(c) (1970), which operates when shareholder action is taken but proxies are not solicited, applies to the very situation when typically no minority votes are needed. That section requires dissemination to shareholders of "information substantially equivalent to the information which would be required to be transmitted if a solicitation were made . . . ." *Id.* There has to be at least as strong a policy for accurate and complete information to the holder, such as the appellant here, whose vote is solicited but not needed. *See* Bromberg § 4.7(556), at 86.23 (1973). As Judge Fulham wrote in Weiss v. Sunasco Inc., 316 F.Supp. 1197, 1205 (E.D. Pa.1970), a post-*Mills* decision, "As I understand *Mills*, the proper test is whether the proxy solicitation is 'an essential link in the accomplishment of the transaction' giving rise to the litigation, irrespective of the fact that other possibilities were available to management." The equities call for protection of the minority shareholder when he is the most helpless, as when neither disinterested director nor disinterested shareholder voting exists as a safeguard. To require strict causation would "sanction all manner of fraud and overreaching in the fortuitous circumstance that a controlling shareholder exists." Swanson v. American Consumer Industries, Inc., 415 F.2d at 1331.

[13] It is true that appellant brought his action for damages before the merger when indeed he could have sued to enjoin. The argument is made that by failing to seek an injunction the appellant is precluded from recovery. We disagree. Appellant may well have felt that in the end an injunction would cost everyone more money and create greater problems for all. Or he might have been required to post a bond for damages and been unable to pay the premium.

The court below said that "the deficiency of the instant complaint stems from the absence of any allegation of injury which was caused by the proxy violations, *aside from that claimed to flow from the unequal ratio*" (emphasis added). Of course, there was injury flowing from the unequal ratio in terms of a lesser value of stock received by the minority Continental shareholders in the merger. Again, if it is reliance to which Judge Metzner was referring, the analogous 10b–5 cases of Superintendent of Insurance v. Bankers Life & Casualty Co., *supra*, and Affiliated Ute Citizens v. United States, *supra*, put this defense aside. To hold otherwise would make the proxy requirements a farce. *Affiliated Ute* holds that causation is sat-

isfied by a material omission when there is a duty to disclose.

[14] The minority shareholders, aside, there are two other purposes served by the disclosure requirements which make a strict causation rule—whether under a 10(b) or a 14(a) claim—antithetical to it:

1. By disclosure the *market* will be informed, so as to permit well-based decisions about buying, selling and holding the securities involved in the transaction. *See generally* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969). Thus, had there been full disclosure here, the merger ratio would have been unfair on its face and the shares of Penn-Dixie in the open market would have sold for less.

2. By virtue of the disclosure either modification or reconsideration of the terms of the merger by those in control might be effectuated. We cannot assume that even a rapacious controlling management would necessarily want to hang its dirty linen out on the line and thereby expose itself to suit or Securities Commission or other action—in terms of reputation and future takeovers.[15] *See Swanson I*, 415 F.2d at 1332; Rosenblatt v. Northwest Airlines, Inc., 435 F.2d 1121, 1124 (2d Cir. 1970); Laurenzano v. Einbender, 264 F.Supp. at 361.

In short, we refuse to adopt the narrow view of causation for which the appellees argue. Instead in the light of the *Mills* footnote, *Affiliated Ute*, *supra*, the Seventh Circuit's *Swanson I* and *Swanson II*, and the other cases in our own circuit above referred to, we are of the view that sufficient causation is alleged so that the complaint must not be dismissed. None of what we say, of course, goes to the merits of the case; that must await trial on the facts.

Judgment dismissing the complaint is hereby reversed and remanded.

FRANKEL, District Judge (concurring):

I concur in the result and in most of the court's opinion. With all deference, however, I am unable to join completely in the opinion because of those portions which employ the concepts of "loss causation" and "transaction causation." While these terms have had some scholarly currency, as the majority shows, and while they may prove eventually to be useful, I am not convinced at this time that the Circuit ought to be committed to their employment or to their still uncertain implications.

The appeal before us arises on a bare pleading. The terminological questions explored by the majority have not been briefed or argued. It does not appear that the issues as the parties presented them require such exploration.

I am not prepared to find these labels either useful or harmful. I conclude only that, being unnecessary, they ought not to enter into an opinion on the limited questions before the court.

15. In this regard it might well be observed that since the merger ratio here was based upon such factors as market price and recent earnings (Joint Proxy Statement at 3) and since it is alleged that those prices and earnings were manipulated by the appellees, the omissions in the proxy statement stand as a definite causal link in the transaction in question. But for the omissions and misstatements, the merger terms may have been so obviously unfair that the appellees would not have attempted the transaction on those terms.

APPENDIX C

Order Denying Petition for Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-seventh day of December, one thousand nine hundred and seventy-four.

Present:

HON. JAMES L. OAKES,
Circuit Judge,
HON. MARVIN E. FRANKEL,
HON. ROBERT J. KELLEHER,
District Judges.

Docket No. 73-2677

—o—

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Plaintiff-Appellant,

v.

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, DANIEL H. ESCHEN, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, OLIVER K. PARRY, PAUL WINDELS, JR., GEORGE C. GREEN, ERIC M. JAVITS, and JAMES F. MORRILL,

Defendants-Appellees.

—o—

A petition for a rehearing having been filed herein by counsel for the appellees,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

A. DANIEL FUSARO
Clerk

Order Denying Petition for Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-seventh day of December, one thousand nine hundred and seventy-four.

Docket No. 73-2677

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Plaintiff-Appellant,

v.

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, DANIEL H. ESCHEN, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE, OLIVER K. PARRY, PAUL WINDELS, JR., GEORGE C. GREEN, ERIC M. JAVITS, and JAMES F. MORRILL,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellees, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

WILFRED FEINBERG
Acting Chief Judge

APPENDIX D

Statutes and Rules

Section 14(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78n (a), provides:

> "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 14a-9 (17 C.F.R. § 240.14a-9) provides:

> "*False or misleading statements.* No solicitation subject to §§ 240.14a-1 to 240.14a-10 shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication written or oral containing any statement which at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

Statutes and Rules

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), provides:

> "Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 (17 C.F.R. § 240.10b-5) provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud,
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

SUPREME COURT, U. S.
FILED
APR 11 1975
MICHAEL RODAK, JR., CLE

In The

Supreme Court of the United States

October Term, 1974

No. 74-1155

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE and JAMES F. MORRILL,

Petitioners,

vs.

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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In The

Supreme Court of the United States

October Term, 1974

No. 74-1155

PENN-DIXIE CEMENT CORPORATION, JEROME CASTLE, OMAR J. GLANTZ, JAMES C. JACOBSEN, HARVEY KUSHNER, ALFONSO J. MARCELLE and JAMES F. MORRILL,

Petitioners,

vs.

JOHN SCHLICK, individually and on behalf of all purchasers of the common stock of Continental Steel Corporation similarly situated,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below are set forth in petitioner's appendices A—C and the jurisdictional requisites are adequately stated in the petition.

QUESTIONS PRESENTED

1. Was the United States Court of Appeals for the Second Circuit correct in holding that a claim upon which relief may be granted is stated under Securities and Exchange Commission Rule 10b-5 by a complaint which alleges a fraudulent course of conduct contrived by a majority shareholder culminating in a merger with another company controlled by that majority shareholder and resulting in the merging out of minority shareholders at a manipulated and unfair exchange ratio?

2. Does the complaint properly plead a private claim on behalf of minority shareholders under Section 14(a) of the Securities Exchange Act and Rule 14a-9 thereunder?

STATEMENT OF THE CASE

Respondent sues on his own behalf and on behalf of all shareholders of Continental Steel Corporation ("Continental") similarly situated. The defendants below are Penn-Dixie Cement Corporation ("Penn-Dixie") and the directors of Continental and Penn-Dixie.

The action arises under the federal securities laws and has its genesis in the merger of Continental into a wholly owned subsidiary of Penn-Dixie.

Penn-Dixie caused the circulation of proxy material which initiated the corporate action culminating in the merger.[1]

In substance, it is alleged that Penn-Dixie, while owning 53% of Continental's issued and outstanding stock and with a compelling need on Penn Dixie's behalf to complete a merger embarked upon a plan and scheme by which Penn-Dixie and Continental (through Penn-Dixie's dominance of Continental's board) caused the intrinsic and market value of Continental's shares to be decreased and the value of Penn-Dixie's shares to be increased thereby facilitating the "merging out" of Continental's minority shareholders (including respondent) at an exchange ratio unfavorable to the Continental minority.

Three important facts relating to the Penn-Dixie-Continental merger must always be borne in mind. First, Penn-Dixie itself was under economic constraint to effectuate the

1. This writ is here upon the reversal of a judgment dismissing the action in the District Court for failure to state a claim. Accordingly, the factual allegations of the complaint must be assumed to be true. *Conley v. Gibson*, 355 U.S. 41 (1955).

merger. Pursuant to the terms and conditions of a loan agreement through which Penn-Dixie had borrowed $25,000,000, the loan would be accelerated to become due if the Penn-Dixie-Continental merger was not completed by June 30, 1973. Thus, while Penn-Dixie had obvious reasons for compelling the merger, the record is barren of any legitimate purpose for making Continental a merger partner. Secondly, a majority of the Continental board was vitally concerned with the continued economic well being of Penn-Dixie since they were Penn-Dixie nominees. Thirdly, while the merger exchange ratio gave Continental minority shareholders a value of approximately $17 per share (Penn-Dixie's estimate), Penn-Dixie was carrying its 53% interest in Continental at approximately $42 per share. Thus, if Penn-Dixie had placed a value upon its own holdings even approaching the substantially lower exchange ratio, generally accepted accounting principles would have required the amortizing of the excess of cost over asset value which, in turn, would have resulted in Penn-Dixie sustaining a very substantial dimunition of earnings (or loss) in the year of the merger and a substantially lower book value. Penn-Dixie thus had established a double standard in the valuation of Continental stock, dependent wholly on whose hands that stock was in.

The essence of the complaint is that there are two intertwined wrongs. First, that in connection with the merging out of the Continental minority, the defendants engaged in a course of conduct which was designed to and did have the effect of altering the exchange ratio upon the merger to the detriment of the Continental minority thus constituting a violation of Rule 10b-5. Second, this scheme or artifice to defraud culminated in

the issuance of false and misleading proxy material. This proxy material is an element of the overall scheme to defraud and also constitutes the basis for a claim for violation of §14(a) of the Securities Exchange Act of 1934, and Rule 14a-9 thereunder.

The components of the scheme to take unfair advantage of the Continental minority constitute both overt acts and in turn, elements of nondisclosure in the proxy material. See opinion below, 507 F.2d at 378-9.

At all times, Penn-Dixie had the power, through its stock ownership, to carry the merger question at the Continental shareholders' meeting. It is this fortuitous state of facts upon which petitioners urge reversal, but as the court below held, naked power is not enough to excuse violations of federal securities laws.

ARGUMENT

Introduction

In the name of advocacy, the petitioners have placed the cart before the horse. We shall attempt to place the issues before this Court in their proper order and in a realistic perspective.

Petitioners devote the vast majority of their petition to the claim arising under Rule 14a-9 (the "Proxy Rule" claim) while giving short shrift to the Rule 10b-5 claim. Admittedly, the Proxy Rule claim and its relationship to the so-called *Mills* open question (see, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385, n. 7 (1970)) is of academic interest. See, *e.g.*, Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 Yale

L.J. 107 (1970). A resolution of that open question, however, will have no effect whatsoever upon the respective rights of the parties. It is submitted that, even assuming that the Proxy Rules claim was never even included in the complaint, the respondent and the class he seeks to represent would nontheless have a good and valid claim against Penn-Dixie and the individual defendants pursuant to Rule 10b-5. For this reason we follow the chronology of the court below and turn first to the Second Circuit's approval of the Rule 10b-5 claim and the propriety thereof.

The Rule 10b-5 Claim

The court below has concluded:

> "Thus, the complaint completes the showing necessary to state a claim under Rule 10b-5. It alleges a specific scheme to defraud (a scheme which includes the proxy solicitation as a part, but which included substantial collateral conduct as well); the fraud was accomplished in connection with a securities transaction; the appellant was a seller in that transaction; and as a result of the sale, appellant alleges a loss was sustained." 507 F.2d at 381.

It is respectfully submitted that this conclusion falls well within the parameters of existing and long settled law and is congruent with the decisions of this Court and of the Courts of Appeals which have construed the Rule. Indeed, the Rule 10b-5 claim is sustainable and was sustained below without reference

to *Mills, supra,* and its open question. The Rule 10b-5 portion of the decision below is in the mainstream of the evolution of the law in this field as reflected by decisions of this Court and of the Second Circuit Court of Appeals. See, *Affiliated Ute Citizens v. United States,* 406 U.S. 475 (1972); *Superintendent of Insurance v. Bankers Life & Casualty Co.,* 404 U.S. 6 (1971); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 495 F.2d 228 (2d Cir. 1974); *Laurenzano v. Einbender,* 448 F.2d 1 (2d Cir. 1971); *Chasins v. Smith Barney & Co.,* 438 F.2d 1167 (2d Cir. 1970); *Globus v. Law Research Services, Inc.,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970); *Heit v. Weitzen,* 402 F.2d 909 (2d Cir. 1968), *cert denied,* 395 U.S. 903 (1969); *List v. Fashion Park, Inc.,* 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965).

Any analysis of the Rule 10b-5 claim must begin with the holding of this Court that a violation of the Rule may derive from the improper use of the proxy solicitation process. *SEC v. National Securities, Inc.,* 393 U.S. 453 (1969).

The petition before this Court misperceives the issues before the court below and distorts that court's holding.

The real issue before the Second Circuit on the Rule 10b-5 question was one of causation. See 507 F.2d at 380. The opinion below does not, as contended in the petition, break new ground in the Rule 10b-5 field. There is nothing new or earthshaking in this decision. At the threshhold the court below was putting ". . . to rest . . . a slow to die contention" that Rule 10b-5 governs fraud in the securities market place only and that it should not extend to those misdeeds which are arguably

actionable under state law. First of all, regardless of whether state law might afford a remedy "where Rule 10b-5 properly extends, it will be applied regardless of any cause of action that may exist under state law." *Popkin v. Bishop*, 464 F.2d 714, 718 (2d Cir. 1962)[2] quoted at 507 F.2d 379-80.

Indeed as this Court has stated:

> "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under §10(b), *whatever might be available under state law. Bankers Life, supra* at 168 (emphasis added)."

Relying upon decisions of this Court and upon other decisions within the Second Circuit, the court below found the requisite causation in fact. There is no better way to establish the propriety of the decision below than to quote from it:

> "This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concedely there would have to be a showing of both loss causation — that the misrepresentations or omissions caused the economic harm — and transaction causation — that the violations in question caused the appellant to engage in the transaction in question. The former is demonstrated rather easily by proof of some

2. Although injunctive relief was denied in *Popkin*, a claim for damages is still being pursued via a class action not unlike the one at bar. See *Popkin v. Wheelabrator-Frye, Inc.*, par. 94, 091 CCH Fed. Sec. L. Rptr. 1973 Transfer Binder (S.D.N.Y. 1973).

form of economic damage, here the unfair exchange ration, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more. In a misrepresentation case, to show transaction causation, a plaintiff must demonstrate that he relied on the misrepresentations in question when he entered into the transaction which caused him harm. . . . In an omission or nondisclosure case based upon Rule 10b-5, a plaintiff need not show reliance in order to show transaction causation but must still show that the facts in question were material 'in the sense that a reasonable investigator might have considered them important' in making his investment decisions.

Under the 10b-5 count, proof of transaction causation is unnecessary by virtue of the allegations as to the effectuation of a scheme to defraud which includes market manipulation and a merger on preferential terms, of which the proxy omissions and misrepresentations are only one aspect. Thus appellant need only show loss causation with respect to his claim for relief under 10b-5; Judge Metzner found and we agree that this has been shown. Here the complaint clearly alleges that, as a result of the merger, appellant was forced to sell his Continental shares to Penn-Dixie on the basis of an exchange ratio that reflected adversely the manipulated

> market value of Continental stock, and that he sustained injury accordingly." (507 F.2d at 380-1; citations and footnotes omitted.)

Petitioners now argue that the decision below and particularly the above quotation permits conversion of state law grounded wrongs into Rule 10b-5 claims.

This is not the case because the complaint alleges and the court below rightfully assumed that the acts done by petitioners leading up to the merger[3] were performed with a view toward affecting a change in the merger ratio. The statement by petitioners (Petition 18) "But neither *Bankers Life* nor any other decision of this Court has done away with the requirement that there must be what has been consistently defined as fraudulent or deceptive conduct, rather than acts of corporate mismanagement such as are alleged here," is the classic straw man, neatly constructed; quickly dispatched. It has, however, no relationship to the issues of this case. Petitioners appear to confuse deception or for that matter, non-disclosure with the concepts of "new fraud" found in Rule 10b-5. Yet the "forced seller" concept is well ingrained in Rule 10b-5 and actionable misconduct under the Rule exists whether or not the forced seller makes a cognitive choice or whether or not he pursues or forebears from pursuing a volitional course of conduct in connection with his sale.

Rule 10b-5 speaks in the disjunctive and one of its proscriptions is:

---

3. *I.e.*, Alteration of Continental's accounting methods, use of Continental's funds as compensating balances for Penn-Dixie's loans, artificial inflation of Penn-Dixie's book value. See 507 F.2d at 378-9.

> "(3) to engage in act, practice or course of business which operates or would operate as a fraud or deceit upon any person."

It is this portion of the Rule which is invoked here; and this portion of the Rule is operative even when conduct is disclosed, but the reasons for the conduct are not. It is axiomatic that the "deception" which petitioners claim is lacking, may always be found in fully disclosed acts which are not unlawful (much less actionable under state law) when the acts are performed for an unlawful purpose. *O'Neil v. Maytag,* 339 F.2d 764 (2d Cir. 1964); *Cochran v. Channing Corp.,* 211 F. Supp. 239 (S.D.N.Y. 1962). The requirement of deception in those cases was satisfied through the finding that a lawful act was done for an unlawful purpose. Thus, the District Court in *Cochran v. Channing, supra,* 242-3 stated as follows:

> "In the instant case the complaint charges more than a simple failure to disclose . . . . It alleges that as part of the scheme to increase its holdings of Agricultural the defendants caused a reduction of the dividend so as to depress the price of the stock. Plaintiff relies upon this affirmative act in support of the complaint.
>
> The fact that the defendants did not make any statements at all does not, in and of itself, deprive plaintiff of relief. The three subsections of Rule 10b-5 are in the disjunctive, and while subsection (2) seems to require a statement of some sort, subsections (1) and (3) do not. One who causes a

> reduction of dividend in order more cheaply to purchase the shares of a corporation is most certainly employing a device to defraud and is engaging in a course of business which operates as a fraud upon the seller of those securities."

Thus, like *Cochran* and the myriad cases which follow it, the case at bar presents a Rule 10b-5 claim based upon the perpetration of at least arguably lawful acts performed for an unlawful purpose; the merging out of the Continental minority. Of course, this concept despite the protestations of Penn-Dixie is not particularly new to our jurisprudence. See, *e.g., United States v. Rabinowich,* 238 U.S. 78 (1914); *Bannon v. United States,* 156 U.S. 464 (1895); *Sundry Goods, Wares and Merchandises (American Fur Company) v. United States,* 27 U.S. (2 Pet.) 355 (1829).

The use of lawful means to effectuate a result actionable under Rule 10b-5 has recently been passed upon in *Bryan v. Brock & Blevins Co.,* 343 F. Supp. 1062 N.D. Ga. 1972), *aff'd,* 490 F.2d 563 (5th Cir. 1974). There a corporation was set up by the majority shareholders of a closely-held corporation for the sole purpose of "merging out" a minority shareholder.

As the District Court stated (343 F. Supp. at 1070):

> "The proposed merger itself was a course of business which would operate as a fraud or deceit upon [the minority shareholder] in connection with the sale of his stock . . . . To allow Brock & Blevins [the corporation engineering the merger]

> to arbitrarily select a time in which to forcefully exclude a minority's interest through unlawful employment of an apparently lawful procedure is not to be condoned by this Court."[4]

It is appropriate to, at last, halt the continual waving of the "bloody shirt" of state law remedies to ameliorate the predicament of the Continental minority. The plain facts are that no such remedies exist! A derivative Rule 10b-5 action challenging the transactions here at issue has been dismissed on grounds of lack of capacity to sue derivatively after the merger had been consummated, (*Schlick v. Castle,* 74 Civ. 1623 [S.D.N.Y.] opinion of Marvin Frankel, U.S.D.J., January 15, 1975). It is quite clear that Judge Frankel's decision would act as a bar to a state law derivative action as well, as his decision turns on a question of the capacity to sue under Indiana law (Continental's state of incorporation). In substance, a federal claim based upon an implied right of action under the federal securities laws brought through the vehicle of a class action is the *only* way to test the propriety of the Continental Penn-Dixie merger and its effect upon the Continental minority.

What then does the Rule 10b-5 portion of the decision below stand for? Certainly it represents no radical departure from existing law.

The case stands for no more than the following:

4. The case at bar presents an even more extreme set of facts than *Bryan, supra.* Here, as noted in the opinion below, 507 F.2d at 382, the Continental minority did not even have the option of state law appraisal under Indiana law. Penn-Dixie securities were literally forced down their throats.

(a) That Rule 10b-5 will be applied in appropriate cases whether or not such a case is actionable under state law. For this proposition, there is ample authority in *Bankers Life, supra,* and *Popkin v. Bishop, supra.*

(b) That a causal relationship exists between the injury to merge out minority shareholders and a scheme to alter intrinsic and market values in preparation for a merger. This too is grounded upon existing law. *Affiliated Ute Citizens, supra; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra.*

To summarize, the issues raised by the Rule 10b-5 claim do not involve mere claims of mismanagement, but rather acts involving a scheme anticipatory of the merger. Nor should the fact that a proxy solicitation was an element of the wrong lead to the confusion that causation here is related in any way to the *Mills* open question. The solicitation function of the challenged proxy material has no bearing on this side of the ledger. The issue is not the approval of the merger, but rather the underlying reasons for effecting the merger in the first instance, and the terms foisted on the Continental minority.

The Proxy Rules Claim

As noted above, this Court in *Mills, supra,* left open the definitional question of whether a sufficient quantum of causation exists in a private Proxy Rules claim where the proponent of the question submitted for shareholder approval owned the requisite shares to carry the question.

The court below has answered that question by finding that causation in fact exists whether or not arithmetical certainty exists with respect to the outcome of the shareholder vote.

The decision of the Court of Appeals should be left undisturbed.

As the court below pointed out (507 F.2d at 383):

> "In the end, we must remember the 'broad remedial purposes' of the Securities Act. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963). Indeed, Mills itself, while leaving the question open, as we have pointed out, by holding that there was a sufficient causal relationship in a proxy case by proof that the proxy solicitation itself rather than the particular defect in the solicitation materials was an essential link in the accomplishment of the transaction, 396 U.S. at 385; 90 S. Ct. 616, lends some support to a more moderate view of transaction causation."

The court below rejected out of hand, the imposition of a "but for" causation standard[5] to private rights of action brought pursuant to the Proxy Rules. By doing so, the decision below chooses to follow the principle first established by this Court in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). *Borak* teaches us that the securities laws and the rules adopted pursuant to those laws

5. This standard of causation is to be found in *Barnett v. Anaconda Co.*, 238 F. Supp. 677 (S.D.N.Y. 1967) and its progeny. These cases, overruled by the instant case, stood for the proposition that so long as the results of a shareholder vote were predetermined because of the existence of a majority shareholder-proponent of the question, a private right of action under Rule 14a-9 was not stated because of lack of causation.

work to establish a framework of broad remedies for those involved in securities transactions.

Should this Court re-institute the arithmetical approach to causation espoused by the petitioners, that framework would be seriously undermined. The legislative intent underlying the securities laws was that common law remedies were insufficient to protect investors and others involved in securities transactions from the "morals of the market place."

It would therefore be a step backward to apply a common law tort standard when such a standard had long ago been found inadequate.

Boiled down to its essential terms, petitioners protest that the decision below creates liability in the air, but as the Second Circuit Court of Appeals stated "in a very real sense, shareholders were deceived by the action of those making the corporate decision to merge." 507 F.2d at 382.

Petitioners argue that the Second Circuit's decision constitutes an abandonment of the concept of causation as an element of the wrong sued upon. This is entirely incorrect. What the Second Circuit has done is abandoned "but for" or "arithmetical" causation for a new standard of causation exemplified by the decision in *Affiliated Ute Citizens, supra.* There is causation in the case at bar. As the Court below stated:

> ". . . we are of a view that *sufficient causation* is alleged so that the complaint must not be dismissed." 507 F.2d at 384 (emphasis added).

It is clearly established then, that rather than abandoning causation as an element of the wrong, the Second Circuit has simply opted for a definition of causation which is entirely appropriate when applied to an implied right of action under the Federal securities laws.

The direction of this Court to its subordinate federal courts in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) was to fashion federal remedies for the invasion of federally created rights. As was pointed out by the court below:

> "Affiliated Ute holds that causation is established by a material omission when there is a duty to disclose." 507 F.2d at 384.

What petitioners seek on this petition, therefore is nothing more than a review of the definitional standard adopted by the Second Circuit in conformity with the mandate of this Court in *Borak* and *Affiliated Ute*. It is clear that that definitional standard is eminently correct and should not be disturbed.

The legislative purpose underlying federal scrutiny of proxy solicitation would, as the court below pointed out, be subverted if such scrutiny is deemed meaningless when minority votes are not necessary to carry proposed shareholder action.

> "The equities call for the protection of the minority shareholder when he is most helpless, as when [as here] neither disinterested director nor disinterested shareholder voting exists as a safeguard. To require strict causation would

> sanction all manner of fraud and over-reaching in the fortuitous circumstance that a controlling shareholder exists . . ." 507 F.2d at 383 (citations omitted).

Upon analysis, what petitioners also ask this Court to do is to engraft onto the Proxy Rules, a precondition to the bringing of an action which would require a showing that the injured party surrendered rights extrinsic to the solicitation process because he was deceived by the inadequacy of the soliciting material (*i.e.*, had the truth been disclosed, he would have sought an injunction or sought appraisal).

First of all, such a showing is made in the case at bar. While, the Continental minority had no right of appraisal (507 F.2d at 382), they had the right to go into the marketplace to sell. The circulation of a false and misleading proxy statement had the effect of locking the price of Continental stock into a ratio of Penn-Dixie's, both of which prices, the complaint alleges, were manipulated to create a patina of fairness in the merger.

Therefore, the acts leading up to the circulation of the proxy material and the circulation itself, had the effect of depriving the Continental minority of the fair price of their stock. Thus "but for" the acts complained of, Continental shares would be worth more. The Continental minority must therefore be deemed to have surrendered the fair value of their shares because of the violation.

In any event, and as an abstract principle, there should be no requirement that the damaged minority shareholder be

volitionally involved in his injury (such as in common law fraud). There is a broad statutory and administrative scheme here to be given effect and the teeth in that network of protection is the right to pursue a private right of action. The target of such an action is not exonerated merely because he has the naked power to achieve a given result. Simply stated, neither §14(a) of the Securities and Exchange Act nor Rule 14a-9 do away with the requirement of full and fair disclosure where a majority stockholder exists. To do away with the liabilities which flow from a breach of that requirement where such a majority stockholder exists "... would make the proxy requirements a farce." 507 F.2d at 383.

Finally, petitioners urge that the decision below is in conflict with the decisions of another Circuit, *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326 (7th Cir. 1969) *(Swanson I)* and 475 F.2d 516 (7th Cir. 1973) *(Swanson II)*. The decisions, however, are harmonious. The essence of the *Swanson* decisions are the statements in *Swanson I* 415 F.2d at 1331-2

> "The power to effect a given result does not negative all possibility of injury resulting from the fraudulent or manipulative use of that power."

and the Court's statement:

> "We are not prepared to sanction a rule of causation which would presume that full disclosure to minority shareholders could have no transactional function in corporate affairs." *Id.* at 1332.

Petitioners beg the question when they quote from *Swanson II* to the effect that ". . . causation between the deception and injury has not been established. . . ." 475 F.2d at 518, since the *Swanson* decisions define causation as a duty to disclose coupled with an omission to disclose, together with economic damage. Such a holding conforms not only with the decision of the Court below, but with the decision of this Court in *Affiliated Ute Citizens, supra.* There is no conflict between the circuits.

CONCLUSION

The petitioners call this action a "strike suit" (Petition 12) and "legalized blackmail" (Petition 18). The Continental minority would say that this action represents an attempt to remedy the effects of as blatant a corporate rape as one could imagine. But epithets, regardless of their derivation, are of no assistance in the resolution of lawsuits. We are here merely testing the sufficiency of the complaint. The decision of the Second Circuit was eminently correct. Its decision on the Rule 10b-5 claim followed a well trod course and does not represent a departure from existing law. The decision on the Proxy Rules claim is consonant with the evolution of the law in that field, represents no conflict with the decisions of any other circuit and should be left undisturbed. The petition for a writ of certiorari should be denied.

Respectfully submitted,

s/ Ira W. Berman
Attorney for Respondent

Jeffrey L. Zivyak
Of Counsel

APR 10 1975
MICHAEL RODAK, JR., CLERK

IN THE

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Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

Respondent necessarily concedes that the proxy rules causation issue expressly left open by this Court in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), "is of academic interest" (p. 5).* We submit, however, that the interest in this issue is far more than "academic," since it is central to a substantial number of the proxy rules cases now pending before the courts.

Respondent also concedes that the present decision has, for the first time, "rejected out of hand, the imposition

* References in parentheses are to the Brief of Respondent in Opposition.

of a 'but for' causation standard to private rights of action brought pursuant to the Proxy Rules" (p. 15);* departed from "common law tort standard[s]" of causation (p. 16); and eliminated the "requirement that the damaged minority shareholder be volitionally involved in his injury (such as in common law fraud)" (pp. 18-19).

We naturally differ with Respondent as to whether this departure from common law standards is desirable or even constitutional. But, irrespective of the merits, it cannot be gainsaid that it is of critical importance in the development of the securities laws, and, therefore, should be reviewed by this Court.

Respectfully submitted,

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* Contrary to respondent's contention (pp. 15-16), it was pointed out by Judge Mansfield that this Court's decision in *J. I. Case Co.* v. *Borak*, 337 U.S. 426 (1964), "required that plaintiff demonstrate 'but for' causation, *i.e.*, that the corporate action would not have occurred in the absence of the alleged violation of the proxy rules." *Kaminsky* v. *Abrams*, 281 F. Supp. 501, 506 (S.D.N.Y. 1968).